

The economic crisis and the reform of financial markets

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There is wide consensus today on the need to reform international financial markets. The financial sector has been the main factor leading to the current global economic crisis, which originated in the US financial system, to later spread across countries worldwide, finally turning into a crisis of the real economy, with a particular negative impact on Europe.

Governments of developed countries have made significant fiscal efforts between 2007 and 2010 to preserve their financial systems, avoiding bankruptcies and thus a general economic collapse. At the same time, fiscal stimulus plans had been put in place to restore aggregate demand, which fell drastically as a consequence of the lack of confidence and the dysfunctional activity of credit markets.

These fiscal efforts, coupled with a fall in public revenue due to the slow down of economic activity, have multiplied the deficit and debt levels of countries, which have recently reached high figures. This has been the case particularly in Europe, but also in the US, although both regions are responding differently to this problem.

In the European Union, financial turbulences registered in April and May 2010, caused by the crisis of Greek public debt and speculation against public bonds issued by other member States are behind the fiscal consolidation process that the EU has just started. In Spain, the Government has recently passed an important fiscal adjustment plan for 2010 and 2011, with the objective of reducing public deficit from 11% to 3% GDP between 2010 and 2013. Similar plans are being adopted in other European countries, including Germany, France, UK, Italy and Portugal. At the same time, the EU was forced to urgently establish a special fund of 750 billion euro as a mechanism to send a clear signal to markets that the governments will counteract any speculative attack against the euro.

It will be important that this fiscal consolidation process be done at an appropriate pace; excessively rapidly consolidation, especially throughout the EU, could lead to a marked economic slowdown, or even a double dip recession. To mitigate the adverse effects of the reduction in aggregate demand, careful attention needs to be paid to the structure of expenditures and taxation. In addition, these measures should be accompanied with a clear strategy for a sustainable economy, with reforms that introduce incentives to improve debt control, intergenerational equity and environmental sustainability, as well as better functioning, cohesion and productivity in financial and labour markets, in lines with those that the Spanish Government is putting in

place.

In the U.S. too there is discussion of fiscal consolidation, though there is within the Obama administration an awareness of the risks of premature expenditure cuts. Within Congress, however, support for a strong jobs bill or even extending unemployment benefits as hundreds of thousands of Americans reach the end of their benefits appears limited. Continuing problems in mortgages markets and elsewhere have led most forecasters to be pessimistic about a return to full employment any time soon.

One might have thought that the European fiscal adjustment was the kind of economically sensible measure that in principle would satisfy financial markets. However, once countries have started to implement corrective measures, a new threat emerges: the potential negative impacts of the cuts in public expenditure on growth could translate into higher debt to GDP ratios, and hence lower public debt ratings. Even more seriously, simultaneous abrupt reductions in public deficits in several European countries could reduce European growth and employment further. It is now evident that consolidation may fail to restore the confidence of financial markets.

To many it seems, therefore, that it is not democratic governments and citizens who hold the real economic power anymore, but the (often capricious) financial markets that were at the root of the crisis. It is evidently urgent that governments around the world must react to these trends, coordinated in the G-20, introducing effective regulation of the financial markets.

It is not acceptable that a high volume of financial operations remains widely undisclosed and unregulated, as trades are made outside organised markets. On the other hand, the financial sector does not pay taxes begin any way commensurate with their profitability, the bonuses they pay their executives, or the negative externalities that financial transactions are proving to entail.

As historic experience has shown centuries ago in maritime transport, when it was legal for an investor to contract insurance on a boat that was not of his/her property, he/she had a clear incentive to make the boat sink. Many boats disappeared as a consequence of that rule, which was finally reformed. Today, the same perverse incentives exist for investors in financial markets, where it is possible to contract insurance on government bonds without owning the underlying securities through "naked" credit default swaps. When the institution that contracts them is a big investment bank or a rating agency, which can influence the public debt market, their natural interest is to make the country sink so

that it is unable to repay the debt.

In addition to reforming the regulation of financial markets and products, it is also desirable that the G-20 considers the introduction of taxes on financial markets, to change the existing adverse incentives and make financial operators compensate their societies for the negative externalities their activity often generates.

In a report prepared by IDEAS Foundation, which was presented in Madrid on May 28th, the authors examine the different alternatives to tax financial markets, which are compatible amongst them and have different objectives. According to this study, among the tool with the best properties would be a tax on Financial Transactions, which is very loosely based on the old idea of the Tobin tax, but applied to all transactions and not only to foreign exchange markets. This tax, with a low rate of around 0.05%, would reduce the volume of speculative short term operations, which can contribute to market volatility, and it could at the same time raise considerable revenue, between 1.600 and 6.300 million euro per year, only in Spain.

Other alternatives studied include a tax on capital gains of short term transactions or a tax on the value added of financial institutions, such as the Financial Activity Tax (FAT) that the IMF is considering. Such taxes would also contribute to the reduction of short term speculation and improve banks indebtedness ratios and risk taking respectively. Other countries are in the process of designing new taxes on banks assets, to provide funds associated with the restructuring of financial institutions facing bankruptcy, a similar mechanism to the Spanish Fund for Deposits Guarantee.

The debate on the introduction of financial markets taxes is very active, which already represents a significant step forward. However, words will need to be turned into action, for which the leaders gathered in the G-20 summit will have to overcome national pressures from their financial systems, to implement taxation which is both efficient economically and fair. Significant steps in this direction have been taken last week, when the EU members agreed to hold a unified position in the G-20 summit concerning the tax on banks, which the EU countries will adopt regardless of the G-20 outcomes, and the establishment of a tax on financial transactions, very similar to the one IDEAS proposed.

The outcome of today's discussions and negotiations can make a big difference to our future. Citizens around the world are watching and expecting their leaders gathered at the G-20 to show the courage and determination to undertake the reforms that the system clearly requires, in order to eliminate some of the problems that have been in the origin of the crisis, and to avoid that it can be repeated in the future. The costs of inaction would be large, both economically and politically.